

# Memorandum

**TO:** HONORABLE MAYOR AND  
CITY COUNCIL

**FROM:** Scott P. Johnson

**SUBJECT: DOLCE HAYES MANSION:  
APPROPRIATION INCREASE**

**DATE:** June 23, 2006

Approved

Date

6/23/06

Council District: CITY-WIDE

## SUPPLEMENTAL

### REASON FOR SUPPLEMENTAL

On June 20, 2006, the City Council deferred taking action on staff's recommendation for Appropriation Increase for one week on Dolce Hayes Mansion in order to receive responses to questions related to this action. Eight questions were asked and responses are shown below for each.

In addition to the responses to Council's questions, staff is providing some additional information by placing this request in the context of other City owned facilities that are operated and managed by outside organizations.

Under the ten year management agreement with the City, Dolce International is responsible for managing and operating the Hayes Mansion facility and in return, receives a management fee of 3% of monthly gross revenues.

It is important to note that the "subsidy" recommended by staff is not for operating purposes, but instead will help fund the City's 2005-06 debt payments on the facility. In the current fiscal year, a net operating income of \$450,000 is projected (prior to City debt payments).

The Hayes Mansion is in a unique position, being the only City facility that does not receive some form of annual operating subsidy. Annually, the City provides operating subsidies to seven organizations that range from \$300,000 to \$4.1 million. These facilities include: Children's Discovery Museum, San Jose Museum of Art, Tech Museum of Innovation, San Jose Repertory Theatre, Mexican Heritage Plaza, History San Jose and the convention center and theatres operated by Team San Jose.

Additionally, the facilities listed above were all constructed by the San Jose Redevelopment Agency and debt financing for these capital investments, which ranged from \$7.7 million to \$114 million, are an obligation of the Redevelopment Agency, not the City, and the debt payments are not funded through the operations of the facilities.

**Question 1 - Provide performance comparisons between Dolce for the current fiscal year with the last 12 months of operation by Hayes Renaissance Limited Partnership (HRLP).**

Hayes Mansion  
FY 2005-06, HRLP Last 12 Months NOI Comparison

	HRLP Actual Nov 02 - Oct 03	Dolce Forecast FY 2005-06	Variance
Total Revenue	7,977,000	13,550,000	5,573,000
Less:			
Direct Expenses	(5,146,000)	(7,800,000)	(2,654,000)
Indirect Expenses	(3,865,000)	(5,100,000)	(1,235,000)
Gross Operating Profit	(1,034,000)	650,000	1,684,000
Fixed Expenses	(177,000)	(200,000)	(23,000)
<b>NET OPERATING INCOME (NOI)</b>	<b>(1,211,000)</b>	<b>450,000</b>	<b>1,661,000</b>

Based on the analysis of net operating income (NOI), Dolce is profitably operating the Hayes Mansion. FY 2005-06 NOI is forecast to exceed the net operating loss incurred during the last twelve months of operations under the control of HRLP by approximately \$1.7 million. The FY 2005-06 forecast based on the current information (as of April 30, 2006), indicates the NOI will be achieved. The following chart illustrates that the cash requirement is not a subsidy of Dolce Hayes operating activities, but rather a subsidy of debt service and other expenses.

	HRLP Actual Nov 02 - Oct 03	Dolce Forecast FY 2005-06	Variance
<b>NET OPERATING INCOME (NOI)</b>	<b>(1,211,000)</b>	<b>450,000</b>	<b>1,661,000</b>
City Administrative Expenses	0	(166,000)	(166,000)
City Debt Service	0	(2,732,000)	(2,732,000)
Leasehold Rent	(2,332,000)	0	2,332,000
Comerica Interest Expense	0	(252,000)	(252,000)
Other Interest Expense	(474,000)	0	474,000
<b>Net Income (Loss)</b>	<b>(4,017,000)</b>	<b>(2,700,000)</b>	<b>1,317,000</b>
Additional Cash Outlays:			
Debt Service	(471,000)	0	471,000
Capital Leases	(107,000)	0	107,000
Capital Expenditures	(882,000)	0	882,000
Term Loan Principal Payments	0	(500,000)	(500,000)
FF&E 4% Reserve	0	(550,000)	(550,000)
<b>Cash Requirements</b>	<b>(5,477,000)</b>	<b>(3,750,000)</b>	<b>1,727,000</b>

### Occupancy Rates

Occupancy rates have increased dramatically since Dolce has taken over management of the Hayes Mansion. As illustrated below, the increased occupancy rate represents a 105% increase over the rate during the last twelve months of operations of the facility under HRLP.

HRLP Occupancy Rate (Nov 2002 – Oct 2003)	25.5%
Dolce Occupancy Rate (FY 2005-06)	52.2%

### **Question 2 – Describe past Council actions that have provided assistance to the Hayes Mansion.**

#### HRLP Financial Assistance

- FY 2002-03 – On September 24, 2002, Council authorized the City Manager to negotiate and execute an amendment to the Second Amended and Restated Agreement to Lease by and between the City and Hayes Renaissance, L.P. (HRLP) to facilitate short term economic relief for HRLP, in a total amount not to exceed \$4.85 million, including utilization of the Hayes Mansion Trust Fund and the capital reserve account in the Community Facilities Revenue Fund for payment of the Phase I and Phase III debt service (\$1.85 million) and providing a line of credit in the amount of \$3.0 million to HRLP for necessary operating expenses.

On June 17, 2003, Council authorized the City Manager to negotiate and execute an amendment to the Third Amended and Restated Lease Agreement extending the deferral of rent. The additional rent deferral totaled \$643,000.

- FY 2003-04 – On September 16, 2003, Council authorized the City Manager to negotiate and execute the Second Amendment to the Line of Credit Agreement with HRLP, increasing the amount of advances available under the Line of Credit Agreement by \$600,000 to a not to exceed amount of \$3.6 million.

#### Transition from HRLP to Dolce – Assumption of HRLP Debt

- FY 2003-04 - On October 21, 2003, Council authorized the City Manager to negotiate and execute a term loan with Comerica in an amount not to exceed \$2 million to payoff existing HRLP debt. In addition, Council authorized the City Manager to negotiate and execute an agreement with Devcon Construction Inc. to assume repayment of the principal of a loan made to HRLP in the amount of \$1.2 million on a subordinated basis from Hayes Mansion net revenues.

#### Transition from HRLP to Dolce – \$5 million Line of Credit (LOC)

- FY 2003-04 - On October 21, 2003, Council authorized the City Manager to negotiate and execute a line of credit (LOC) agreement in an amount not to exceed \$5 million with Comerica bank for the purpose of providing operating cash flow needs for the Hayes Mansion. The LOC was used to fund shortfalls totaling \$200,000 during the two month period (November 2003 – December 2003) that HRLP operated the property under the terms of a transition operating agreement, open the new Dolce Hayes Mansion bank

accounts (\$250,000) and fund shortfalls (\$4.55 million) subsequent to January 1, 2004 when Dolce took over management of the property.

*Financial Assistance under Dolce Management Agreement*

- FY 2004-05 – The General Fund Appropriation Adjustment Actions for FY 2004-05 established a transfer and loan to the Community Facilities Revenue Fund in the amount of \$1 million for the purpose of funding Hayes mansion operating shortfalls.

On April 12, 2005, Council approved the use of excess monies totaling \$2.06 million in the debt service reserve fund for the purpose of repaying a portion of the outstanding balance on the Comerica Line of Credit, thereby allowing the City to re-borrow these funds from Comerica on an as needed basis to provide cash flow needs for Hayes Mansion operations.

- FY 2005-06 - An amount of \$1.6 million (General Fund) was appropriated as part of the FY 2005-06 budget adopted by Council to fund Hayes mansion operating shortfalls.

***Question 3 - Describe Dolce's strategies/marketing plans that have resulted in financial improvements.***

Dolce, as a major conference center operator, builds its success on the principle that each property must have a Sales and Marketing plan that clearly outlines Strategic Action Plans that are specifically tied to the conference center's operating budget. Dolce works with the General Manager and Director of Sales and Marketing to create a Marketing Business Operating Plan that consists of specific targeted strategic actions that are measurable and time sensitive.

The Director of Sales and Marketing develops a Yearly Sales & Marketing plan consisting of Strategic and Tactical action plans that have been carefully prepared by the Sales and Planning Team. The plan is reviewed monthly and updated quarterly based on the success that each individual team member has in implementing the plan. Monthly updates are provided in a narrative format to Dolce and City staff members. Dolce also hires professional Global Sales Managers and mandates on-going sales and marketing training to insure that sales results are realized. Each Global Sales Manager and Conference Sales Manager is assigned specific targeted revenue and room night goals that are aligned with the operating budget. These goals are measured monthly and coaching is provided by the Director of Sales and Marketing and Director of Sales on an on-going basis.

Recent accomplishments are summarized below:

- Forecast FY 2005-06 Group Room Nights exceeded forecast of \$3.57 million by \$178,000.
- FY 2006-07 pre-sell of Definite Group Room Nights are 52% higher than the pre-sell of Definite Group Room Nights for FY 2005-06 at the same time last year.
- Dolce's Brand Contribution contributed \$1.4 million in Room Revenue for FY 2005-06 through May 2006.



- Dolce has successfully redeployed the Sales Team to focus on National, Regional and Local business with emphasis on Fortune 1,000 companies' training programs (Series Training Programs). Clients who have returned based on Dolce's efforts in marketing and managing the property include:

Deloitte and Touche

Hewlett Packard

Mckinsey

Apple

Wells Fargo

Intel

- Dolce Hayes Mansion has won a number of awards for outstanding meetings, including the following:
  - 2004/2005/2006 Paragon Award by Corporate Meetings and Incentive Magazine
  - 2006 Pinnacle Award by Successful Meetings Magazine Top 10 Conference Centers in the USA: Only Conference Center in the west to win this award.
  - 2005 Best Sunday Brunch & 2005 Best Spa in Silicon Valley Awards

***Question 4 – Identify impacts to the Hayes Mansion if staff recommendations are not approved and any alternative financial solutions***

If staff recommendations are not approved, the Hayes Mansion will not have sufficient cash to cover its current liabilities. Specifically, debt service of \$1.14 million representing reimbursement to the City for bond related expenses has been incurred but not paid by the Hayes Mansion. The City has continued to remit payments to the bond trustees as required; however, without being reimbursed by the Hayes Mansion, the City's Community Facilities Revenue Fund (which was established by the City to account for the Hayes Mansion debt service activity) will end the fiscal year with a negative available fund balance.

Staff has been unable to identify any alternative financial solutions other than the funding sources contained in the appropriation recommendations and the alternatives we are exploring with Comerica Bank as noted in the staff report.

***Question 5 – What are the opportunities to decrease reliance on the General Fund?***

The City's consultant, Horwath Hospitality & Leisure, has completed a five-year financial projection, including the proposed FY 2006-07 budget. There are two five-year projections shown below. In either case, the reliance on the General Fund decreases each year, except in FY 2007-08 when room renovations are planned and the Comerica line of credit matures. The first projection (Projection 1) completed by Horwath assumes that the City will pay off the Comerica Loan, which is due in October of 2007 of approximately \$5 million and the second projection (Projection 2) assumes the Comerica Loan will be renegotiated with the principal payment deferred to a later date.

Horwath's assumptions include an estimated amount to renovate the rooms in FY 2007-08. It is Horwath's belief that without the renovation, the property will not remain competitive and will not achieve the projected growth in revenue. Horwath has indicated that the industry norm for room renovations is 5 -7 years, and by FY 2007-08 the Hayes Mansion will fall within this timeframe. In addition, all properties within the Hayes Mansion's competitive set have undergone renovations. The renovations being planned include new beds, soft goods and bathrooms at an estimated cost of \$5 million (approximately \$23,000 per room).

### Projection 1

Hayes Mansion  
Five Year Projection

**Assumes \$5 million Line of Credit is paid off in October 2007.**

	Proposed Budget FY 2006-07	Projection FY 2007-08	Projection FY 2008-09	Projection FY 2009-10	Projection FY 2010-11
Total Revenue	15,250,000	17,274,000	18,907,000	20,595,000	21,446,000
Less:					
Direct Expenses	(8,600,000)	(8,993,000)	(9,439,000)	(9,925,000)	(10,260,000)
Indirect Expenses	(5,600,000)	(5,956,000)	(6,175,000)	(6,403,000)	(6,599,000)
Gross Operating Profit	1,050,000	2,325,000	3,293,000	4,267,000	4,587,000
Fixed Expenses	(200,000)	(218,000)	(222,000)	(226,000)	(231,000)
<b>NET OPERATING INCOME</b>	<b>850,000</b>	<b>2,107,000</b>	<b>3,071,000</b>	<b>4,041,000</b>	<b>4,356,000</b>
City Expenses	(200,000)	(210,000)	(217,000)	(224,000)	(232,000)
City Debt Service	(3,425,000)	(3,799,000)	(4,254,000)	(4,504,000)	(4,825,000)
Comerica Interest Expense	(325,000)	(75,000)	0	0	0
Net Income (Loss)	(3,100,000)	(1,977,000)	(1,400,000)	(687,000)	(701,000)
Additional Cash Outlays:					
Capital Improvements - Renovation	0	(5,000,000)	0	0	0
Line of Credit Repayment	0	(5,000,000)	0	0	0
Term Loan Principal Payments	(500,000)	0	0	0	0
FF&E 4% Reserve	(600,000)	(691,000)	(756,000)	(824,000)	(857,000)
<b>Cash Requirements</b>	<b>(4,200,000)</b>	<b>(12,668,000)</b>	<b>(2,156,000)</b>	<b>(1,511,000)</b>	<b>(1,558,000)</b>

**Projection 2**

Hayes Mansion  
Five Year Projection

**Assumes \$5 million Line of Credit due Oct. 2007 will be renegotiated and extended beyond FY 2010-11.**

	Proposed Budget FY 2006-07	Projection FY 2007-08	Projection FY 2008-09	Projection FY 2009-10	Projection FY 2010-11
Total Revenue	15,250,000	17,274,000	18,907,000	20,595,000	21,446,000
Less:					
Direct Expenses	(8,600,000)	(8,993,000)	(9,439,000)	(9,925,000)	(10,260,000)
Indirect Expenses	(5,600,000)	(5,956,000)	(6,175,000)	(6,403,000)	(6,599,000)
Gross Operating Profit	1,050,000	2,325,000	3,293,000	4,267,000	4,587,000
Fixed Expenses	(200,000)	(218,000)	(222,000)	(226,000)	(231,000)
<b>NET OPERATING INCOME</b>	<b>850,000</b>	<b>2,107,000</b>	<b>3,071,000</b>	<b>4,041,000</b>	<b>4,356,000</b>
City Expenses	(200,000)	(210,000)	(217,000)	(224,000)	(232,000)
City Debt Service	(3,425,000)	(3,799,000)	(4,254,000)	(4,504,000)	(4,825,000)
Comerica Interest Expense	(325,000)	(325,000)	(325,000)	(325,000)	(325,000)
Net Income (Loss)	(3,100,000)	(2,227,000)	(1,725,000)	(1,012,000)	(1,026,000)
Additional Cash Outlays:					
Capital Improvements - Renovation	0	(5,000,000)	0	0	0
Term Loan Principal Payments	(500,000)	0	0	0	0
FF&E 4% Reserve	(600,000)	(691,000)	(756,000)	(824,000)	(857,000)
<b>Cash Requirements</b>	<b>(4,200,000)</b>	<b>(7,918,000)</b>	<b>(2,481,000)</b>	<b>(1,836,000)</b>	<b>(1,883,000)</b>

**Question 6 – How much of the principal would need to be paid down in order to have a positive cash flow?**

Current principal is approximately \$67 million (including the Comerica LOC and Term Loan). Assuming interest rates rise in 2006-07 to 5% the principal would need to be reduced by \$54 million to bring the remaining debt to \$13 million. The interest only payments on this remaining principal amount of \$13 million would be \$650,000. The 2006-07 budget for the Hayes Mansion projects a net operating income (NOI) of \$850,000. The only items to be paid from this balance are the City administrative expenses budgeted at \$200,000, leaving \$650,000 to be paid on the loans. This would take the net cash to zero, as follows:

NOI from Hayes	\$850,000
City Administrative Expenses	<u>\$200,000</u>
Cash Available for Debt	\$650,000

The amount of principal to be paid down is an inverse function of NOI; therefore, as NOI increases over the next 5 years, the amount necessary to pay down the debt decreases.

**Question 7 – What are the options for the sale of the property? What impact would the debt owed on the mansion have on potential buyers?**

Assuming continued use as a conference center, Horwath has indicated that based on market pricing by brokers, current conditions would suggest an asking price in the range of \$25,000,000 to \$30,000,000 or approximately 2 times annual gross revenue; less commissions (approximately 3 – 3.5%) and closing costs, with potential credits for any deferred maintenance and possible needed renovations. Since the buyer would pay what it deems a market price, there would be no effect on the buyer of any City debt above the sale price.

It should be noted that if the property was brought to market after the next fiscal year, the asking price would increase to a range of \$38,000,000 to \$42,000,000 due to the expected increases in NOI in FY 2007-08. This assumes that market cap rates remain steady. As illustrated in the table below, as Dolce continues to be successful in marketing the facility and gross annual revenues continue to increase, the estimated sales price increases proportionately. Using one of the industry standards as noted above, the table below provides estimated sales prices over the 5-year financial projection based on 2 times annual gross revenue:

	Proposed Budget FY 2006-07	Projection FY 2007-08	Projection FY 2008-09	Projection FY 2009-10	Projection FY 2010-11
Estimated Sales Price (2 X Gross Rev)	30,500,000	34,548,000	37,814,000	41,190,000	42,892,000

If Council directs staff to determine the value considering the potential use as something other than a conference center, a consultant would need to be hired to determine the highest and best use. This process would take approximately 3-4 months at an estimated cost ranging from \$30,000 to \$50,000.

**Question 8 - How does the information in the Monthly Financial Report (MFR) about the subsidy relate to the financial projections?**

The February 2006 MFR indicated current estimates for subsidy levels required for at least the next several years total approximately \$4.2 million annually. This amount was an estimated annual average subsidy over the next several years, which included renovation costs anticipated for FY 2007-08. At the time of this estimate, a formal 5 year projection had not been completed.

Based on a 5 year projection recently completed by Horwath Hospitality & Leisure, the average annual subsidy for FY 2006-07 through FY 2010-11 is projected to be \$3.7 million, including renovation costs of \$5 million tentatively planned for FY 2007-08. Not considering the renovation costs, the average annual subsidy for the next five years is projected to be \$2.7 million.



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The above information assumes that the repayment of the \$5 million Comerica line of credit (LOC) due in full in October 2007 will be extended beyond FY 2010-11. However, if the LOC is not extended, but paid off in October 2007, the average annual subsidy over the next five years, including renovation costs, is projected to be \$4.4 million. Without renovation costs, the average annual subsidy is projected to be \$3.4 million.

### **COORDINATION**

This item has been coordinated with the City Manager's Office.

  
SCOTT P. JOHNSON  
Director, Finance Department

For questions please contact Scott Johnson, the Director of Finance at (408) 535-7000.

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